



Atlanta Calgary Chicago Houston London New York Singapore

WRITTEN TESTIMONY OF JEFFREY S. SPRECHER
CHIEF EXECUTIVE OFFICER
INTERCONTINENTAL EXCHANGE, INC.
BEFORE THE HOUSE
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

JUNE 9, 2009

Chairman Kanjorski, Ranking Member Garrett, I am Jeff Sprecher, Chairman of the Board of Directors and Chief Executive Officer of IntercontinentalExchange, Inc., or "ICE." I very much appreciate the opportunity to appear before you today to testify on over the counter (OTC) derivatives regulation.

Background

In the mid 1990s, I developed power plants in California and witnessed the state's challenge in launching a spot market for electricity. The problems arose from a complex market design and partial deregulation. I was convinced there was a more efficient and transparent way to manage price risk in the wholesale markets for natural gas and electric power. Therefore, in 1998, I purchased a small energy trading platform in Atlanta, which was then called the Continental Power Exchange. This became the electronic over-the-counter (OTC) energy platform when ICE was formed in 2000. The ICE OTC platform was designed to bridge the void that existed between the voice brokered OTC markets which were bilateral and opaque, and the open-outcry futures exchanges, which were inaccessible or lacked the products needed to hedge in the power markets.

Since the launch of its electronic OTC energy marketplace in 2000, ICE has acquired and now operates three regulated futures exchanges through three separate subsidiaries, each with its own governance and regulatory infrastructure. The International Petroleum Exchange (renamed ICE Futures Europe), was a 20-year-old exchange specializing in energy futures when acquired by ICE in 2001. Located in London, it is a Recognized Investment Exchange, or RIE, operating under the supervision of the UK Financial Services Authority (FSA). In early 2007, ICE acquired the 137-year-old "The Board of Trade of the City of New York" (renamed ICE Futures U.S.), a CFTC-regulated Designated Contract Market (DCM) headquartered in New York and specializing in agricultural, foreign exchange, and equity index futures. In late 2007, ICE acquired the Winnipeg Commodity Exchange (renamed ICE Futures Canada), a 120-year-old exchange specializing in agricultural futures, regulated by the Manitoba Securities Commission, and headquartered in Winnipeg, Manitoba.



ICE also owns and operates five derivatives clearinghouses:

- ICE Clear US, a Derivatives Clearing Organization under the Commodity Exchange Act, located in New York and serving the markets of ICE Futures US;
- ICE Clear Europe, a Recognized Clearing House located in London that serves ICE Futures Europe and ICE's OTC energy markets;
- ICE Clear Canada, a recognized clearing house located in Winnipeg, Manitoba that serves the markets of ICE Futures Canada.
- ICE Trust, a U.S.-based CDS clearing house. In March 2009, the Federal Reserve Board of Governors approved ICE Trust's application to become a member of the Federal Reserve System. ICE Trust began clearing CDS transactions on March 9, 2009.
- The Clearing Corporation, established in 1925 as the nation's first independent futures clearing house. It provides the risk management framework, operational processes and clearing infrastructure for ICE Trust. The Clearing Corporation also provides clearing services to the Chicago Climate Futures Exchange.

ICE has an established a track record of working with OTC market participants to introduce transparency and risk intermediation into markets. We have also worked closely with regulators to improve supervision and access to information. Along with the introduction of electronic trading in energy markets ICE pioneered the concept of cleared OTC energy swap contracts. These changes to a traditionally opaque, bilateral market structure, made in response to a market crisis in the energy markets in 2002, have dramatically transformed the way risks are managed by market participants around the globe. These reforms have been replicated by nearly every other exchange in an effort to develop commercial services addressing the vast and global OTC marketplace across interest rates, commodities, credit, foreign exchange and equity derivatives. With this background, I come before you today to testify on the regulation of OTC derivatives.

Need for OTC Regulation

Appropriate regulation of OTC derivatives is of utmost importance to the financial system. Presently, many derivatives transactions are largely exempt from regulation by financial regulators. ICE believes that increased transparency and proper risk and capital management, coupled with legal and regulatory certainty, are central to OTC market financial reform and to restoring confidence to these vital markets.



In discussing the need for OTC regulation, it is important to understand the size of the OTC derivatives markets and their importance to the health of the U.S. economy. Derivatives are commonly thought to be complex financially engineered products transacted between large investment banks. However, the reality is more complex, as an OTC derivative can encompass anything from a forward contract (a promise of delivery in the future) between a farmer and a grain elevator to a complex instrument like a credit derivative or collateralized debt obligation. Derivatives are central to the U.S. and global economy: 94% of the world's 500 largest companies use derivatives to manage their financial risk.¹ These companies are not constrained to the financial sector; health care, industrial corporations, and technology companies regularly use derivatives to manage risk. Importantly, use of derivatives is not confined to large corporations, as small utilities, farmers, manufacturing companies and municipalities use derivatives to hedge risk. It also bears emphasizing that derivatives — both futures and OTC instruments — will play a central role in any “cap and trade” program to combat climate change.

Examining the scope, complexity and importance of the OTC derivatives, one draws the conclusion that “one size fits all” regulation will not work. Simply banning products or participants will only create further disruptions in the market and harm U.S. businesses and markets, leading to a reliance on other venues outside the US to manage risk. Financial regulation must be well defined, flexible and prudential. Flexibility is important, as it allows regulators to respond to future problems, not just yesterday's crisis. Prescriptive law and regulations hamper regulatory flexibility and create regulatory gaps. To be flexible, regulators must be prudential, understanding their markets and tailoring regulation to ensure market integrity and consumer protection.

Regulators need clear lines of jurisdiction. Several of the OTC instruments at the heart of the financial crisis were in regulatory gray areas between one or more regulators. Regulators need certainty that they have the power to take actions to uphold the public good. Likewise, market participants need the certainty that their business transactions will not be held to conflicting standards of conduct. Further, regulatory certainty eliminates the possibility of regulatory arbitrage, or long-term damage to the competitiveness of the U.S. in a highly competitive global environment.

The need for certainty extends beyond U.S. borders. It is vital to recognize that the OTC derivatives markets are international: the majority of the large companies globally use derivatives, and they conduct these transactions with U.S. counterparties. Thus, U.S. regulators must work with international regulators from a common set of regulatory principles. Harmonizing regulatory systems across countries will eliminate the probability that OTC derivatives transactions will flee to jurisdictions where they are least regulated or least restricted.

¹ Study by the International Swaps and Derivatives Association (April 23, 2009). <http://www.isda.org/press/press042309der.pdf>



Clearing and Electronic Trading

Transparency is a pre-requisite for efficient markets and effective regulation. In ICE's introduction of electronic trading and clearing to the power markets — which were the domain of voice brokered, bilateral transactions — brought transparency to previously opaque markets. Now, OTC energy contracts are centrally listed and predominately cleared, with attendant benefits such as counterparty risk mitigation as well as a complete audit trail of all transactions. Overall, ICE's development of clearing and electronic trading has promoted competition and innovation in the energy derivatives market, to the benefit of both market participants and consumers. The increased liquidity from clearing and electronic trading has resulted in lower transaction costs and tighter bid/ask spreads, reducing the cost of hedging energy price risk and lowering operating costs for businesses.

Recently, ICE began clearing credit default swaps, or CDS, through its regulated central clearing house, ICE Trust. Credit derivatives facilitate the hedging of the risk of a credit event, such as the downgrade in a company's debt, or the risk of default. In a basic credit default swap, the buyer agrees to make a payment or series of payments to the seller. In return, the seller agrees to pay the buyer in the event of the default. Traditionally, the credit market was organized like interest rates, foreign exchange and other OTC markets: most transactions are bilaterally executed through intermediaries rather than through an exchange. Critically, the bilateral nature of the market leaves participants exposed to counterparty risk, among other things, such as a lack of an accepted mark-to-market on a daily basis. In times of great financial distress, like the present, this risk can have systemic implications. When financial counterparties do not trust each other, and are unable to hedge their credit risk, then they stop lending to each other and the credit markets freeze. However, counterparty risk can be mitigated through clearing.

ICE Trust began clearing credit default swaps on March 9, 2009. Since then, ICE Trust has cleared over \$800 billion in credit default swaps, with resulting open interest, or net exposure, of \$125 billion. With the support of its twelve clearing members, ICE Trust has grown both in volume and the number of contracts cleared. With each clearing cycle, ICE Trust reduces counterparty and systemic risk. The results are transparent to the public: open interest, volume, and pricing information are posted on ICE's website.² ICE has made substantial investments to develop an industry leading risk model, independent governance and a legal framework to bring confidence, transparency and regulation to these markets.

² Open interest and volume can be found at ICE's website: <https://www.theice.com/marketdata/reportcenter/reports.htm?reportId=98>. Pricing data can be found here: <http://www.markit.com/cds/cds-page.html>



Mandating Clearing and Exchange Trading

Turning to the topic at hand, clearing and electronic execution and trade processing are core to ICE's business model. As such, ICE would clearly stand to benefit commercially from legislation that required all derivatives transactions conducted in the U.S. to be cleared and traded "on exchange". Clearing all OTC derivatives and the trading of OTC derivatives on a transparent electronic platform may provide additional risk management and, potentially, additional price transparency. However forcing all OTC derivatives to be cleared and traded on exchange would likely have many unintended consequences.

In the derivatives markets, clearing and exchange trading are separate concepts. At its core, exchange trading is a service, offering order matching to market participants. While futures exchanges can serve a valuable price discovery function; listing a contract on an exchange does not necessarily mean better price discovery. Exchange trading works for the highly liquid products, such as the Russell 2000 or the Brent Crude Oil contract that appeal to a broad set of market participants. However, for other markets, exchange trading is not the best solution, as the market may be illiquid, with wide bid/offer spreads, leading to poor or misleading price signals. Nonetheless, these illiquid products can still offer a value to hedgers, and thus have a place in the OTC derivatives markets. Forcing trades onto exchanges would only increase costs to hedgers while potentially providing misleading pricing information.

Turning to clearing, this technique greatly reduces counter party and systemic risk in the derivatives markets for standardized contracts. However, forcing unstandardized contracts into a clearinghouse could actually increase market risk. Accurate price discovery is essential for the clearinghouse to mark open positions to market. Where market depth is poor or contracts are not standardized, the margin and risk mutualization cost will be very high -- and thus uneconomic for market participants -- given the necessary conservatism on the part of a clearing house. So while ICE certainly supports clearing as much standardized product as possible, there will always be products which are either non-standard, not sufficiently liquid, or that do not have enough interest in them for clearing to be practical, economic or necessary. While the illiquid and unstandardized contracts should not be forced to be cleared, firms dealing in these derivatives should report them to regulators, so regulators have a clear and total view of the markets.

U.S. businesses, like all businesses around the globe, often require bespoke OTC derivatives. Exchange traded contracts must appeal to the broadest set of market participants. While these contracts have a broad set of market participants, the contracts



do not offer efficient hedging services to all. For example, airlines use bespoke fuel swaps to hedge jet fuel for particular locations where no futures contract exist. When no exchange traded substitutes are available to efficiently hedge this risk, airlines take their hedging needs to intermediaries who write custom swaps, and hedge this and other clients' exposure on futures and OTC exchanges. This bespoke hedging need is clearly not limited to energy, as many firms hedge foreign currency risk through OTC derivatives. In fact energy is among the smallest of the OTC markets globally. Similarly, agricultural companies use OTC swaps to hedge price risk that cannot be offset in the futures markets. In sum, forcing exchange trading would increase risk and costs to U.S. firms; while forcing all OTC derivatives to be cleared would increase risk to clearinghouses and result in uneconomic margin for certain products.

In any financial reform measure, it is important to note the benefits of the CFTC's tiered regulatory structure for exchanges and electronic trading platforms. As stated above, futures exchanges list contracts that appeal to the broadest set of market users. In 2000, Congress recognized that electronic platforms could fill an important gap between the strictly off-exchange voice brokered markets and the traditional futures exchange to trade OTC derivatives. ICE's OTC platform is an exempt commercial market (ECM). Trades on an ECM are principal to-principal, with no intermediaries, between highly sophisticated parties. As an electronic platform, ICE can list hundreds of niche OTC energy products that appeal to limited number of market participants. When traded on an ECM, these transactions are transparent to participants and to regulators. ECM trading encourages standardization, which in turn encourages clearing. In the ICE's experience, when a market is able to be cleared, market participants overwhelmingly prefer to have their transactions cleared. If the ECM lists a product that grows into a contract that serves a significant price discovery function, then the ECM is obligated to place exchange like regulation on trading of that contract. Retaining this tiered regulatory structure and expanding it to other markets will be important to achieving the goals of transparency.

Balancing Price Discovery and Liquidity

Many OTC derivatives markets serve a price discovery function for the underlying cash market. It is important that this function be protected. Participants such as commercial users, investment banks, and hedge funds bring different sets of information to the market and form a price consensus. This price discovery process is essential to the U.S. financial system. Thus, it is vitally important that market participants not be banned and that markets not favor one type of participant. For example, some have called for limiting futures markets to commercial users of the underlying cash market. Unfortunately, banning financial participants would ultimately lead to cartel pricing. Financial participation helps increase liquidity, which makes it easier for market participants to get in and out of positions at a given price, and in fact



makes it more difficult for any individual participant to manipulate the market by creating an artificial price. Financial participants are the counterparties to the commercial entities who hedge their production or consumption. Finally, liquidity is essential for efficient clearing and pricing.

In summary, price discovery and liquidity cannot be balanced. Liquidity is necessary for price discovery; a more liquid market creates better pricing information. Thus, there is no existing market that is too liquid. Limiting liquidity or market participants necessarily hampers a market's price discovery process, including market transparency and efficiency.

Conclusion

ICE has always been and continues to be a strong proponent of open and competitive markets, and of appropriate regulatory oversight of those markets. As an operator of global futures and OTC markets, and as a publicly-held company, ICE understands the importance of ensuring the utmost confidence in its markets. To that end, we have continuously worked with regulatory bodies in the U.S. and abroad in order to ensure that they have access to all relevant information available to ICE regarding trading activity on our markets. We have also worked closely with Congress and regulators in the U.S. and abroad to address the evolving regulatory challenges presented by derivatives markets and will continue to work cooperatively for solutions that promote the best marketplace possible.

Mr. Chairman, thank you for the opportunity to share our views with you. I would be happy to answer any questions you may have.